

VZCZCXRO6599
PP RUEHPW
DE RUEHBUL #3334/01 3650725
ZNR UUUUU ZZH
P 300725Z DEC 08
FM AMEMBASSY KABUL
TO RUEHC/SECSTATE WASHDC PRIORITY 6571
INFO RUEHRC/USDA FAS WASHDC PRIORITY
RUCNAFG/AFGHANISTAN COLLECTIVE
RUEKJCS/OSD WASHINGTON DC
RUCPDOG/DEPT OF COMMERCE WASHINGTON DC

UNCLAS SECTION 01 OF 02 KABUL 003334

DEPT FOR SCA/FO, SCA/RA, AND SCA/A
DEPT PASS AID/ASIA BUREAU
USDA FOR FAS OA/GSM/MILLER
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SIPDIS

E.O.12958: N/A
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SUBJECT: AFGHANISTAN RECONSTRUCTION TRUST FUND (ARTF)
UPDATE

SUMMARY

1. At the December 17 Quarterly Donors meeting, the Afghan government met with donors to discuss the Afghanistan Reconstruction Trust Fund (ARTF). The Government of the Islamic Republic of Afghanistan (GIROA) and the ARTF donors approved a proposal to reform the Recurrent Cost Window of the ARTF. The proposal, drafted by a working group consisting of the Afghan Ministry of Finance and donors that included the United States, lays out a gradual decline in automatic budget support through the Recurrent Cost Window. It also establishes an off-setting incentive mechanism to reward the government for achieving economic reform and revenue generation benchmarks to be agreed upon by GIROA and donors during an annual consultation process. If these benchmarks are achieved, incentive funds would be made available as part of the following year's Recurrent Cost Window support. This represents a key step in the future evolution of the ARTF from an emergency support mechanism to a program development fund, and is scheduled to be in place for the upcoming 1388 budget year (March 2009 Q March 2010). Formation of a technical working group is planned for January 2009 with a mandate to produce a draft Financing Strategy by the next ARTF Quarterly Meeting, in March 2009. Program-based budgeting is an important step to align ARTF funding with the Afghanistan National Development Strategy (ANDS) to achieve Millennium Development Goals (MDG).

2. Members of the Technical Working Group that formed as a result of the ARTF Donors Committee meeting in September 2008 to review the findings of the ARTF External Evaluation included the Ministry of Finance (Budget, Revenue, Fiscal Policy, Minister's Office), U.S., UK, Italy, Germany, EC and the IMF. The World Bank facilitated the working group's discussions leading up to the December meeting. END SUMMARY.

AFGHANISTAN RECONSTRUCTION TRUST FUND (ARTF)

13. The ARTF is a multi-donor trust fund administered by the World Bank and funded by 27 donors; mobilizing over USD 2.4 billion by the end of solar year 1386 (March 2008). During the six years since it was established in 2002, the ARTF has been the main source of pooled financing for GIROAQs recurrent budget, but has increasingly supported priority investments in the Government's reconstruction program. At the end of solar year 1386, projects covering infrastructure, rural development, technical assistance (TA), capacity development, and education had a total commitment of over US \$750 million.

14. For solar year 1387 (March 2008 Q March 2009), donors pledged US \$670 million, bringing the six-year total to over US \$3 billion. The main ARTF donors are the United Kingdom, Canada, United States, European Commission, Netherlands, Norway, and Germany. Iran, India and Arab states are also members of the ARTF.

15. Afghanistan is subject to exogenous shocks. Large volumes of off-budget assistance (i.e. the External Budget) mean unpredictability for the future requirements of the core operating budget (including implications of external budget investment on the future core operating expenditures). Insecurity, national elections, and public administration reform also create new and uncertain pressures on expenditures. Therefore, any overall and rapid decline in ARTF Recurrent Cost (RC) support would aggravate Afghanistan's fiscal position, especially in the short-term.

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NEW ARTF RECURRENT COST WINDOW PROGRAM

16. Donors and GIROA approved a new ARTF Recurrent Cost Window mechanism that has the following objectives: 1) predictable ARTF RC funding over the medium-term, improving aid effectiveness; 2) support for GIROAQs core policy reforms, including domestic revenue generation; 3) strengthening the ARTF as a platform for policy dialogue between donors and Government; and 4) clearer strategic objectives for the ARTF RC Window.

17. Starting in solar year 1388 (March 2009 Q March 2010), ARTF RC allocations each year would be twofold; the first part would consist of a sum of a baseline guaranteed amount of annual support. The baseline component will phase out over a set period Q thereby establishing a predictable exit strategy from automatic ARTF support to the operating budget. This exit strategy is to prevent the ARTF from creating perverse revenue generation incentives. The share of ARTF RC support that is linked to the government's core reform program will increase over time. Importantly, this allows for a potential ARTF RC window of approximately US \$270 million for the next three years, an amount that is consistent with GIROAQs Mid-term Fiscal Framework (MTFF) in the ANDS.

18. The second component of the ARTF RC allocations would be a policy and performance based initiative scheme; a multi-year, whole-of-government program to support GIROAQs core reform program. Although specific benchmarks for Solar Year 1388 and the details of the revenue matching grant program are still being finalized, GIROA and the donors approved common themes in three areas: revenue generation, public sector governance, and private sector development. For example, an overall precondition for the incentive component is GIROA remaining on track with the Poverty Reduction Growth Facility (PRGF) program and improved

audit of core budget expenditures. At least some benchmarks will likely reinforce measures that GIROA has committed to under the IMF program. As the scheme proceeds, it is expected that policy discussions will include more line ministries and reflect structural benchmarks that target cross-government reforms.

NEXT STEPS

19. The World Bank's 2008 independent external evaluation of the ARTF also recommended that it develop a Financing Strategy in order to maximize the predictability, efficiency and transparency of ARTF resource allocation. Such a Financing Strategy would establish the principles by which investment funds are allocated. Objectives of the Financing Strategy would be to: 1) increase budget predictability and aid effectiveness; 2) increase alignment of ARTF resources with government priorities and programs; 3) maintain & strengthen donor support for ARTF as a mechanism; 4) increase transparency of ARTF decision-making with regards to resource allocation; and 5) increase the intra-year flexibility of ARTF cash management by reducing preferencing at the project level. A technical working group will convene in January 2009 to finalize benchmarks for solar year 1388, and settle on the exact workings of the revenue matching grant program. It also has a mandate to produce a draft Financing Strategy by the next ARTF Quarterly Meeting in March 2009.

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